Farm Incorporation

Saskatchewan
Agriculture
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Foreword

Favourable tax treatment and high net farm incomes encouraged many farmers to incorporate in the late 1970s and early 1980s. The 1991 census reported 3,047 corporate farms in Saskatchewan or 5% of all farms in the province.

Recent tax changes have significantly affected the income tax benefits of incorporating. Fewer farmers now find incorporation to be advantageous. However, farmers with high net incomes and the desire to expand the size of their farm may still benefit by incorporating, particularly if there are further benefits such as estate planning, limited liability or the need for a farm operating arrangement.

A corporation is a more structured and complex business organization than a proprietorship. Farmers should carefully and fully investigate all the advantages, disadvantages and alternative strategies before incorporating.

Tax calculations are based on 1996 tax laws and rates.

This publication indicates the advantages and disadvantages of farm corporations and provides information on the various means of establishing and operating a corporation. It is intended as a general guide for farmers and is not to be used as a substitute for qualified legal, accounting and tax advice.

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The Nature of a Corporation

A corporation is a separate legal entity that is created under federal or provincial statutes. It can have virtually all the rights, duties and responsibilities of an individual. For example, it can purchase, hold, and transfer property, obtain financing and enter into contracts. Most often, Saskatchewan farmers can accomplish their objectives by organization under the Saskatchewan Business Corporations Act. A corporation registered under the Saskatchewan Business Corporations Act may engage in activities outside Saskatchewan by registering in the jurisdiction in which it operates. Alternatively, when a farm engages in business activities primarily outside Saskatchewan, incorporation under the Canada Business Corporations Act might be considered.

Shareholders of a corporation are its owners. A share is a percentage interest in the equity of the business. For example, a share is a percentage ownership of all the land, buildings, machinery, livestock, feed, grain, supplies and cash after the liabilities of the corporation have been deducted.

Relationship of a Farmer to a Corporation

In a farm corporation, the relationship of the farmer to his business is much different than for a sole proprietorship. The following are some of the roles which may exist in a farm corporation. Note that the same person may perform more than one role in the corporation.

Shareholder: Through the ownership of shares, individuals own the corporation. They elect the directors who appoint officers of the corporation. Shareholders may receive dividends on the shares.

Director: A director is the representative of the shareholder and is responsible for major policy directions and makes major decisions such as the acquisition of assets or arrangements for credit.

Officer: An officer in a corporation directs the day to day business.

Employee: An individual may work for the corporation and receive a salary or wage.

Landlord: An individual may lease some or all of his assets to the corporation and receive rental income.

Lender: An individual may sell assets to the corporation and take back a note, mortgage or some other evidence of debt. The lender may receive interest and/or principal from the corporation until the debt is retired.

Borrower: An individual might borrow money from the corporation for some personal purpose. There are severe tax penalties unless the rules under the Income Tax Act are followed when money is borrowed from a corporation. The individual would be responsible for retiring the loan by paying principal and interest if applicable.

Advantages of a Corporation

Taxation

One reason for incorporating a farm is to achieve income tax deferral and possibly tax savings. The following are the main income tax advantages.

Small Business Tax Rate

In Saskatchewan, the tax rate for a Canadian Controlled Private Corporation is 21.12% on the first $200,000 of active business income each year. There is no cumulative limit. Active business income does not include investment income or capital gains.

Beginning July 1, 1994, the Small Business Tax Rate will be eliminated for corporations with taxable capital employed in Canada exceeding $15,000,000. The benefit will be reduced for those corporations having taxable capital employed of between $10,000,000 and $15,000,000 on a sliding scale.

Because personal marginal tax rates are higher with even moderate levels of taxable income, it is possible to shelter earnings in a corporation and defer the payment of income tax to a later date. This is accomplished by not paying out all the corporate earnings as dividends, wages, salaries or interest but by retaining a portion of the earnings in the corporation. This is referred to as retained earnings. For further discussion of this benefit, see the section entitled "Taxation of Corporate Income".

On income in excess of $200,000 in any year, the corporate tax rate is 46.12% . Since the corporate tax rate is a flat rate, there is no advantage in attempting to sell grain or livestock in one tax year as opposed to another unless the net income exceeds $200,000. Tax management in relation to adjusting taxable income between years is simplified.

Dividends

Shareholders who receive dividends may deduct a dividend tax credit from the Basic Federal Tax. Since the Basic Federal Tax is used to determine provincial tax, the dividend tax credit reduces both federal and provincial tax.

The dividend tax credit reflects the corporate tax paid on its profits. In effect, it is a system which prevents double taxation on the same basic earnings. It ensures that a taxpayer pays approximately the same amount of tax on that income as would have been the case had he earned the income directly rather than through a corporation. For a more detailed discussion, see the section entitled "Taxation of Corporate Income".

Salary Paid to a Spouse

A corporation is able to pay a wage or salary to an individual's spouse, providing that the spouse performed services for the business. Because of Canada's progressive tax system, total personal income tax payable is less to the extent that a husband and wife can split income between them rather than having all the income received by one spouse. In order for this to be effective, the salary paid must be reasonable for the services performed (normally this would be the amount that you would be willing to pay some one not related, for the same work).

This advantage which was previously only available to a corporation has been available to sole proprietorship forms of business since January 1, 1980. Remittance of the required Canada Pension Plan (employee and employer share) and income tax deductions must be made. In addition, unemployment insurance premiums must be deducted unless the employee owns 40% or more of the voting shares of the corporation.

Rollover of Shares

Shares in a "family farm corporation" may be transferred from a parent to a child on a capital gain rollover thereby deferring tax liabilities on the shares to the succeeding generations.

This as well as other aspects of taxation are discussed in more detail in later sections of this publication.

Capital Gains Exemption

Capital gains realized on qualified farm property is eligible for the $500,000 capital gains exemption. Qualified farm property includes shares in a family farm corporation.

A share in a family farm corporation means a share owned by the individual at the time of transfer where:

(a) in any 24 month period prior to the transfer of the shares, more than 50% of fair market value of the property owned by the corporation was property used by the corporation, a permitted user* or the family farm partnership of a permitted user, principally in the course of carrying on the business of farming in Canada and in which any permitted user was actively engaged on a regular and continuous basis; **and**

(b) at the time of transfer of the shares, 90% or more of the fair market value of the property owned by the corporation was used principally in the course of carrying on the business of farming in Canada by the corporation, permitted user or a family farm partnership of a permitted user.

* Permitted users include the following:

- individual;
- spouse of the individual;
- parent of the individual; and
- child of the individual (natural, adopted, step-child, grandchild, great grandchild, son-in-law, daughter-in-law and a foster child).

It should be noted that a corporation that realizes capital gains on the sale of property is not eligible for any capital gains exemption. Only individuals are eligible for the exemption.

Even though an individual can fully shelter a capital gain by using their capital gains exemption, that does not necessarily mean that they will not owe any tax. In Saskatchewan, the individual will be subject to a 2% flat tax on the taxable capital gain, and may also be subject to Alternative Minimum Tax. For further discussion, see the section entitled "Alternative Minimum Tax".

Separation of Ownership, Control and Division of Profits

Normally, a person who owns an asset also controls it in terms of its management and is entitled to receive all the profits from it. There can be advantages for tax planning, estate planning and in transferring property to separate these rights. This can be accomplished in the organization and the structuring of share capital in a corporation.

For example, one class of shares might have voting rights (control), while another class of shares might be entitled to dividends (a distribution of after tax corporate profits). Certain classes of shares might be entitled to share in the growth of the corporation while others might not. Therefore, it would be possible to transfer ownership of a corporation and still retain control.

Flexibility in the Distribution of Income

A corporation may pay out salaries, management fees, rentals, dividends, interest or principal. The type of distribution and the amount can be selected which results in the greatest advantage to the corporation as well as the individual receiving the money.

Estate Planning and Transfers

Corporate shares are easier and less costly to transfer to beneficiaries than is real and personal property such as cattle, grain, etc. It is easier to divide shares which are relatively low in value compared to say a quarter section of land with a much larger value.

The estate of an individual can be frozen in a corporation. This can be accomplished by transferring assets to a corporation and taking back notes and/or non-growth shares which will not increase in value. The growth shares can be issued to other individuals (your children for example) who will realize all future growth in the equity of the corporation.

Limited Liability

The liability of shareholders is limited to the amount paid for the shares. Therefore, an individual's assets owned outside the corporation are protected if the corporation becomes insolvent. The advantage of limited liability is lost if creditors require the personal guarantee of shareholders before credit is extended. A personal guarantee is where the shareholder promises (guarantees) to repay the debt personally if the corporation fails to pay. In many cases, non-financial institution creditors (suppliers for example) may not require personal guarantees.

As long as the shareholder does not act negligently, a corporation can offer protection in the case of third party liability since only the assets of a corporation can be used to settle a liability claim and not those of the shareholders. However, liability insurance can (and should) be purchased to overcome third party liability for corporations, partnerships, and sole proprietorships. The limited liability of a corporation should not be used as a substitute for adequate insurance coverages.

Continuous Existence

A corporation has perpetual existence as long as the shareholders wish and the requirements of the Saskatchewan Business Corporations Act are met. When one of the shareholders dies, the corporation carries on rather than terminates as would be the case when the owner of a sole proprietorship farm dies. However, if the farm corporation is controlled by one person and that person dies, it may be necessary to dissolve the corporation, if no one is prepared to manage the organization.

Grain, feed, supplies and livestock on hand at the date of death of a farmer are called Rights and Things. The value of the Rights and Things must be brought into income either on one of the farmer's estate income tax return or in the return of the beneficiaries. There is a tax advantage to putting the amounts on the farmer's Rights and Things estate income tax return as an additional set of personal tax credits are available.

This tax liability does not occur in the same way when the shareholder of a corporation dies, since the corporation which has perpetual existence owns these assets. It should be noted, however, that upon death, the shareholder may have to pay tax on the value of the company, as the shares are deemed to be sold to the shareholder's estate at fair market value (unless one of the special rollover provisions are used - see the section entitled "Share Transfers and Reorganization").

Pooling Resources and Management Skills

A corporation is a type of business arrangement that allows two or more individuals to pool their resources. This may result in cost savings and improved output through better utilization of labour, management expertise, and capital available (land, buildings, equipment and operating funds). Increased scale of operation may improve market strategies in buying or selling.

Often this benefit can also be obtained through the Partnership form of operation. However, with a Partnership, most of the other limitations that apply to Sole Proprietorships still apply. In addition, joint and several liability results in a Partnership. This means that all partners are individually liable for the full amount of Partnership debts (not just your particular percentage).

Availability of Credit

To the extent that the farm operates on a more business-like basis with better accounting and a larger capital base, it may be easier to arrange for credit.

Keeping the Farm as One Unit

A corporation permits an individual to plan his estate in a manner which allows the farm to remain as one entity, yet permits the division of the estate's value among several beneficiaries through the bequest of shares. For further discussion, see the section entitled "Estate Planning".

Disadvantages of a Corporation

Extra Costs

There are legal and accounting fees to establish a farm corporation as well as annual accounting and legal fees once the corporation is operating.

The Corporations Branch charges a fee for filing the annual return each year plus a fee when the corporation is established.

Additional costs may arise for drawing sales agreements, land transfers, buy-sell agreements, mortgages, issuing shares and the establishment of profit sharing plans. These fees will vary depending on the sophistication level required.

Extra Administration

There are more rules, regulations and formal documentation required for a corporation than for a sole proprietorship. Minutes of meetings must be maintained in an appropriate minute book, an annual meeting is required, an annual return must be filed with the corporations branch, and income tax and accounting requirements are more involved. Although this sounds onerous, in many cases, these requirements can be met with minimal effort.

Because of these extra requirements/complexities, often there will be more consultation with lawyers, accountants and management advisors.

Income Tax

Principal Residence

A corporation cannot own a principal residence as defined in the Income Tax Act. Therefore, when property which includes a house is sold by a corporation, there can never be a capital gains exemption for the principal residence.

Often when farm corporations are established, the house is not transferred to the corporation. The farmer retains title to his house and providing the other conditions relating to a principal residence are met, the capital gain on the sale of the house would be exempt from tax.

Loans to Shareholders

If a shareholder borrows money from his corporation the amount borrowed must be repaid by the end of the corporation's next fiscal year. If it is not repaid within that time period, the amount is included in the shareholder's income for the year the money was borrowed. A shareholder and corporation can not engage in a series of loans and repayments to circumvent these rules.

This rule does not apply if money is borrowed to purchase a dwelling or an automobile or shares of the corporation under certain conditions.

Shareholders should seek professional advice in this area, as they would often find a taxation disadvantage to receiving loans from the corporation.

Taxable Benefits

A shareholder or employee of a corporation is subject to the payment of income tax on certain benefits received. For example, if an individual has personal use of a company car or house, then a value is attached to this benefit which becomes taxable income to the individual. Low interest rate loans are also a taxable benefit.

Normally, it is better for the shareholder/employee to own the car or house as opposed to a corporation. The corporation can reimburse the individual based on usage.

Business Losses Cannot Be Carried Out of the Corporation to an Individual Shareholder

In situations where the corporation experiences business losses, such losses cannot be allocated to shareholders to improve their personal income tax situation. When business losses occur, the combined tax situation of the corporation and shareholders may be worse than if the business had operated as a sole proprietorship.

In many family farm situations, this is a minor disadvantage since most of the shareholder's personal income is a result of payments (salary, dividends, or rents) from the corporation.

Corporation losses may be carried back three or forward ten years within the organization. In this way, tax paid in prior years may be recoverable, or tax on future periods may be reduced.

Active Business Income

Only income defined as active business income realized by a corporation qualifies for the preferential small business tax rate of 21.12%. All other corporate income would be taxed at a rate of 46.12%. Active business income is earnings that are from business rather than property (ie. not interest, dividends, rents or royalties).

High Cost of Dissolving a Corporation

When a corporation is dissolved there are no provisions for averaging or deferring the income tax that may occur when assets are sold or transferred by the corporation. When assets are transferred to shareholders they are deemed to be sold to the shareholder at the fair market value of the assets. The liability for all capital gain or other deferred income is realized when the corporation is dissolved or any assets are sold.

Legal and accounting costs will also be incurred when a corporation is dissolved.

It is possible to undertake a corporate reorganization whereby the assets of an existing corporation are transferred to two or more other corporations without incurring capital gain on the transfer. This is known as a butterfly split whereby two or more shareholders in a corporation could split their business into separate entities. Expert accounting advice should be obtained in such circumstances.

With the high cost of dissolution, a corporation should only be formed if it is intended to have a long life.

Penalties for Personal Use of Corporate Funds

If personal or living costs are paid for by the corporation, it could result in double taxation and penalties to the shareholders and the company. All corporate funds used for such purposes should be accounted for and allocated as salary, dividends or payments on shareholders' loans.

Basic Herd

An election to roll over the basic herd to a corporation may be undertaken. The farmer will be permitted a deduction in the year of the rollover. The basic herd is treated as normal purchased livestock inventory in the hands of the corporation.

Investment Tax Credit

The Investment Tax Credit on assets purchased by a corporation is available for use only by the corporation. Investment Tax Credits carried forward by a corporation cannot be used by a shareholder to reduce his personal Federal Income Tax Payable.

Capital Gains Exemption

The Capital Gains Exemption cannot be used by a corporation to offset capital gains realized on the disposition of assets within the corporation. The deduction is available only to individual taxpayers.

Consequently, a shareholder who disposes of shares of the corporation that result in capital gain could apply the Capital Gains Exemption to the capital gain on the shares.

Careful planning should be undertaken with an accountant to ensure that the full benefit of the capital gain exemption is received.

Alternative Minimum Tax

Alternative minimum tax applies to individuals, including shareholders, but not to corporations. Shareholders in receipt of large amounts of dividends or capital gains may be subject to minimum tax.

Minimum tax is payable if it exceeds the tax calculated in the normal manner. Minimum tax may be payable when certain types of income are received such as dividends or capital gain or deductions are claimed for investment tax credit, share-purchase tax credit, scientific research tax credit, losses from MURBs, film and video tapes, resource expenses, RRSP or pension plan contributions.

In many cases, the taxpayer can, in future years, get back the minimum tax paid. However, one still has to plan on having the required cash flow available for a number of years.

Creditor Protection

Incorporated farmers may have less protection from creditors under Saskatchewan legislation than would sole proprietorship farmers. However, as previously discussed, personal assets may be protected.

Minority Shareholders

Shareholders who have a small number of shares in relation to other shareholders have little power to change the operation of a corporation. Non-farm children are often placed in a minority shareholder position relative to the farming children in a corporation. Their rights to sell the shares or force a satisfactory rate of return on the shares are often restricted. However, the Business Corporations Act does provide certain rights to minority shareholders. In some situations, minority shareholders can force the corporation to purchase their shares.

The bylaws of a corporation can provide some degree of protection for minority shareholders. This is discussed in greater detail later in this publication, in the section entitled "Bylaws of the Corporation".

Loss of Freedom and Individual Identity

A farm corporation is a more complex business organization. It requires time and knowledge to fully understand and master its operation. Many farmers are unwilling to spend the time required to understand the corporate structure and regret having incorporated the farm business.

Many farmers take great pride in owning land, buildings, machinery, livestock and grain in their own name. When a corporation owns these an individual may lose this pride of ownership.

Mineral Acreage Tax

In Saskatchewan, any individual with mineral rights on 3,200 acres or less is exempt from the Mineral Acreage Tax. Farm corporations in Saskatchewan can apply for an exemption from Mineral Rights tax under section 13.1 of The Mineral Taxation Act, 1983. Applications can be

made through Saskatchewan Energy and Mines, Mineral Revenue Branch, Regina, Saskatchewan. This tax can also be avoided by having the individual transfer only the land to a corporation and retain title to the minerals in his own name. Legal advice should be sought to ensure that all requirements are met.

Ability to Work Together

In corporations involving more than one shareholder, the parties must be able to get along. A certain amount of "give and take" is essential. Individuals who have difficulty getting along beforehand may find their differences intensified in a corporation.

Steps in Incorporating

Farms which incorporate should do so after carefully investigating the pros and cons of incorporating and determining which strategies will be best to adopt. Typically there are three steps involved in incorporating a farm. These are:

- investigating and development,
- formation of a corporation, and
- financing a corporation.

Investigating and Development

The structure, operation and alternative organizations of a corporation can be difficult to understand. Therefore, a great deal of investigative time is involved. It may take several months or even years from the time a farmer first considers incorporation to its formation.

Accounting and legal advice should be obtained soon after the idea of incorporating occurs. Normally, it is better to hire a lawyer and accountant to help set up the corporation. However, The Saskatchewan Business Corporations Act has made incorporation quite simple and straight forward. An individual who does some research and reading on his own may complete the incorporation procedure himself. Individuals would be well advised to, at a minimum, have their lawyer/accountant review the work done prior to finalizing the arrangements.

Factors to consider when investigating the merits of a corporation include the following:

- the objectives for incorporating your farm,
- management and control,
- share structure and allocation of shares to shareholders,
- alternative methods of organizing,
- financing, and
- transfer of assets to the corporation.

Formation of a Corporation

Most farms incorporate under the Saskatchewan Business Corporations Act. This provincial statute became effective in 1977 when it replaced the old "Companies Act".

Types of Corporations

Two types of corporations are distinguished in the Act. These are:

- non-distributing (private), and
- distributing (public).

Distributing corporations offer their shares to the public. Distributing corporations must disclose their financial position and comply with the extensive regulations of the Saskatchewan Securities Commission.

Non-distributing corporations (private) are not required to meet the same requirements of a distributing corporation. Therefore, in the majority of cases, farms operate as non-distributing corporations. While a corporation becomes a distributing corporation by its actions, that is,

offering its shares for sale to the public, a corporation may in the Articles of Incorporation include the following to indicate that it is a non-distributing corporation:

- restriction on the transfer of shares,
- prohibition on offering shares to the public, and
- restriction on the number of shareholders.

Number of Shareholders

A corporation can be formed with one shareholder. There is no upper limit to the number of shareholders permitted in a non-distributing corporation.

In a one shareholder company, that person will perform the functions of president, secretary, sole director and sole shareholder.

Name of a Corporation

A corporation's name must be approved by the Corporations Branch, Saskatchewan Government. A name should be selected that is distinctive and represents the nature of the business if possible. Names including "Canadian", "Saskatchewan", "Co-operative", "Pool" or words of a similar nature are not permitted.

The corporation's name must end with one of the following: Limited, Limitee, Incorporated, Incorporee, Corporation, or the abbreviations: Ltd., Ltee., Inc. or Corp.

The Corporations Branch charges a fee for reserving a name. Three selections for a name should be sent in with the application in case one or two are rejected.

Filing Documents with the Corporations Branch

A fee is charged by the Corporations Branch to process the incorporating documents. Duplicate copies of the Articles of Incorporation, Notice of Registered Office and Notice of Directors must accompany the fee.

One stamped copy of each of the above is returned. A Certificate of Incorporation is also issued by the Corporations Branch at this time. These documents should be filed in the corporation's minute book.

Articles of Incorporation

The Articles of Incorporation are really the constitution of the corporation. The following information should be contained in the Articles of Incorporation:

- **Full name of corporation.**
- **Municipality in which registered office is located.**
- **Share structure**: This is the type of shares (e.g., common or preferred) and the maximum number of shares of each class (type) that may be issued if a limitation in the number is intended and if no limit is intended then it should be stated that unlimited is the number.

Any special rights, privileges, restriction or conditions that apply to shares must be stated. The shares may be issued for any consideration desired, however, no par value may be set on the shares. Not all the shares need to be issued. Those shares unissued remain with the corporation and can be issued at a later date.

Normally, to remain flexible, incorporators usually choose to have an unlimited number of shares authorized to be issued.

If there is a limited authorized number of shares specified, the limit can be changed later by filing Articles to amend Articles of Incorporation and by passing a special resolution.

• **Restrictions on share transfers**: The incorporators may wish to place other restrictions on the shares. Possible restrictions include the following:

- Shares may not be transferred to anyone other than an existing shareholder without the approval of the holders of a certain percentage of the shares.

- Shares may not be transferred unless approved in a resolution by a majority of the board of directors.

- Shares may not be transferred without the approval of the holders of a majority of the shares and a majority of the board of directors.

Restrictions on the transfer of shares help to protect existing shareholders.

• **Number of directors**: The minimum and maximum number or a fixed number of directors must be indicated.

• **Restrictions on the business activities of the corporation**: Occasionally restrictions are placed on the business activities of a corporation in order to protect investors. In most cases it is best not to restrict the activities of the corporation in order to permit the greatest flexibility. This is particularly true for small non-distributing corporations with a few shareholders.

• **Other provisions**: A corporation may use this section to indicate that it is non-distributing. This can be done with the following clauses:

- prohibit the offering of shares to the public, and
- restrict share transfers.

• **Incorporators**: The name, address and signatures of the incorporators must be provided.

Notice of Registered Office

The registered office must be in Saskatchewan. The full address of the office must be filed. The registers, minute book and perhaps the accounting records must be available for inspection at this location during business hours.

A registered office can not be a post office box, but must be an actual place of business.

If the registered office is changed, notice must be given to the Corporations Branch within 15 days.

Notice of Directors

Each director's name in full, his address, occupation and citizenship must be stated.

Electing Directors

The following conditions apply to directors:

- the majority of the directors must be Canadian citizens.
- at least one director must be a resident of Saskatchewan,
- be at least age 18,
- be of sound mind,
- be an individual (not a corporation), and
- not be bankrupt.

Directors are elected at the first meeting of the shareholders after incorporation. A director may not have a term greater than three years, but a director may be re-elected for a further term.

Shareholders may remove a director from office by passing a resolution at a special meeting of shareholders.

The Saskatchewan Business Corporations Act provides that directors have certain duties and responsibilities. These include the responsibility of directing the management of the company, and set the rules and regulations governing meetings, directors' conflict of interest and the liability of directors for mismanagement of company affairs. Shareholders may take action against directors who have mismanaged the affairs of the corporation.

Shareholders

Shareholders are the owners of the corporation. At the first meeting of the shareholders after incorporation, the shareholders elect directors to manage the corporation. Directors appoint officers (president, secretary, treasurer) who operate the company.

The line of authority is shareholders who delegate authority to directors, who in turn delegate authority to officers. In small, closely held corporations the shareholders, directors and officers are often the same people. Different people have these responsibilities in larger corporations.

Since the shareholders are the owners of the corporation and assign certain responsibilities to directors, The Business Corporations Act grants shareholders the right to take action against directors in some circumstances. These rights include the following:

- The right to have the corporation redeem the shareholders' shares at fair market value if the corporation makes a fundamental change to its articles, transfers to another jurisdiction, amalgamates with another corporation or sells, leases or exchanges all or substantially all of its property.

- Shareholders may apply to the courts to have the company wound up if the directors improperly manage the corporations affairs.

- Shareholders on behalf of the corporation can take action against directors to prevent the corporation from doing something harmful to itself.

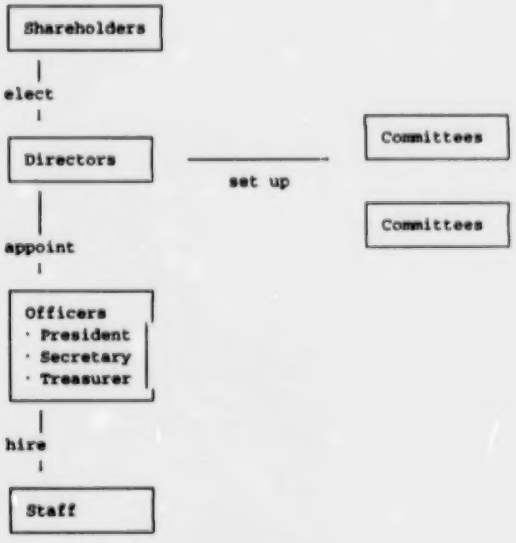
- When the business is carried on in a way which disregards the interest of shareholders, directors, officers or creditors of the company, the shareholders can request a court to order the action stopped. It can also ask that directors be changed or that contracts be cancelled. Compensation may be payable to the person suffering the loss.

- Shareholders can call a meeting of directors if the directors fail to do so.

- A shareholder can ask the court to investigate a corporation if it is suspected that the corporation is defrauding any person, if it disregards the interests of a security holding, or if it operates for unlawful purposes.

Line of Authority

The following figure depicts the line of authority in a corporation.



As previously stated, in small, closely held corporations the shareholders, directors and officers are often the same people.

Bylaws of the Corporation

The bylaws become the rules and regulations that govern the operation of a corporation. Directors may pass a set of bylaws.

If the corporation does not make its own bylaws, then the provisions of The Business Corporations Act of Saskatchewan in effect become the bylaws of the corporation. For a small, private corporation with only two or three shareholders, this may be satisfactory. However, the provisions of the Act should be reviewed to determine if some aspects are not adequate or are inconsistent with the intentions of the incorporators. Bylaws cannot be adopted that are not permitted by The Business Corporations Act.

Amendments or additions to the bylaws can be made at any time and should be filed in the minute book.

The following points should be considered in the corporation's bylaws:

- **Location of registered office.**
- **Provisions for a corporate seal.**
- **Fiscal year.**
- **Signing authorities for contracts and other documents.**
- **Provision for banking arrangements.**
- **Provision for storing securities and shares of the corporation.**
- **Authority to dispose of securities.**
- **Power of directors to borrow money.**
- **The number of directors, the method of their election and their term** can be specified in the bylaws as well as their qualifications and conditions necessary to be a director.
- **Powers of the directors** can be stated and rules for the conduct of meetings.
- **The directors may set up committees** with specific functions to perform.
- **The board of directors appoints officers of the corporation.** The officers include a president, secretary, vice-president, general manager, treasurer and others that are deemed advisable.

Vice-presidents have the powers of the president in his/her absence. The secretary takes minutes at the meetings of the board of directors, shareholders and committees of the board. The secretary properly enters the minutes in the corporation records and gives notice of meetings.

The **treasurer** looks after all corporate funds and securities and maintains proper accounting records.

The **general manager** is appointed by the board of directors. The general manager can be given the authority to manage and direct the business and affairs of the corporation and to supervise employees.

- **An annual shareholders' meeting** is called by the board of directors, or failing it, the president. At the annual shareholders' meeting, reports and statements of corporate affairs are examined, directors are elected, auditors are appointed and other business that may be brought before the meeting is dealt with.
- **The board of directors governs the issue of shares of the corporation.** Shares may not be issued until fully paid for.

Audit Considerations

Under the Business Corporations Act, all corporations must have an annual audit performed on the financial statements. In many family farm situations, this may be an expensive requirement.

If there is unanimous agreement, small privately held corporations can elect not to have an audit performed. This should be noted in the minutes each year. Prior to undertaking this action, discussions with all shareholders, the accountant, and possibly the banker should be held to discuss the advantages and disadvantages in each particular situation.

Other Considerations

After the corporation is established, a bank account should be established and signing officers appointed. It may be desirable to limit the amount of a cheque that may be issued without the agreement of all signing authorities.

In addition, the ownership of insurance policies, land titles, mortgages and vehicle registrations must be changed.

A good accounting system should be established and an accountant hired.

Financing a Corporation

The source of capital for a corporation can be obtained from three sources. These are:

- shares,
- internal financing, and
- external financing.

Shareholders may purchase shares thereby attaining an equity (ownership) position in the corporation. The amount paid for the shares is capital available to finance and operate the corporation.

Internal financing also includes loans made to the corporation by shareholders (shareholders' loans), use of corporate profit to finance the corporation (retained earnings), and the transfer of assets to the corporation by shareholders or others. Normally the corporation will show a debt on its books by way of a shareholder's loan, promissory note or mortgage for the value of assets transferred to it by any person.

Often, there are planning advantages from shareholders purchasing only a nominal amount of shares and loaning (via a shareholder's loan) the remaining capital required upon starting up a corporation. Expert tax advice should be sought prior to finalizing this decision.

External financing occurs when the corporation borrows from commercial lenders such as banks or mortgage companies.

Shares

Shares indicate ownership in the corporation. Depending on the rights attached to shares, the shares may command a portion of the equity in the corporation, a portion of the corporation's profit (a dividend) and the right to a say in how the corporate affairs are handled (voting rights). The Business Corporations Act of Saskatchewan refers to classes of shares (rather than the use of the terms common shares and preferred shares) and different rights that may be attached to different classes. Examples are as follows:

Types of Shares

Preferred shares have a right to dividend payments in priority to common shares. If the company is wound up, the preferred shares have a higher claim to the corporation's capital than would common shares. Preferred shares may be fixed in value and do not change with the growth of the corporation. To some extent, they are similar to shareholders' loans. However, dividends paid on preferred shares are considered dividends

(distributions of after tax corporate earnings), and are therefore not tax deductible to the corporation. For a further discussion of the taxation implications see the section entitled "Taxation of Dividends".

Common shares are entitled to the residual profits of the corporation as a dividend after all other demands have been met. If the corporation is wound up, the common shares are entitled to the remainder of the capital after all other capital demands have been met. All the corporation's growth will accrue to the holders of the common shares. Therefore, common shares may increase or decrease in value depending on how well the corporation does financially.

Classes of shares: Shares can be differentiated by classes to allow slightly different rights. For example, a corporation may have Class A common shares and Class B common shares to allow different rights to different shareholders.

Rights Attached to Shares

Voting rights may be assigned to any type of share whether it be common or preferred shares although most frequently common shares are assigned the voting rights.

Each voting share usually has one vote. One half of the total shares plus one share will carry a decision. Voting shares indicate control. If one individual has more than one half of the voting shares, then s/he has control. Minority shareholders will have little say in the management of the corporation except in situations where under the Business Corporations Act the minority shareholders may exercise their rights in certain circumstances.

Redeemable: This gives the shareholder the right to sell his shares back to the corporation at his/her request (usually at a predetermined amount).

Retractable: This gives the corporation the right to buy back shares from shareholders (usually at a predetermined amount).

Cumulative: If a fixed dividend is payable each year, but no dividend is declared that year because of low earnings (or any other reason), the dividend must still be paid and will accumulate until the corporation is able to pay.

Non-cumulative shares mean that dividends do not accumulate if in one year the corporation does not pay the dividend.

Selecting a Share Structure

In selecting a share structure the shareholders' objectives must be considered. These objectives may include some of the following:

Simple structure: One class of shares such as voting common shares.

Freeze an estate: Note that Estate Freezes are very complex transactions. Individuals would be well advised to seek competent expert help if considering undertaking an Estate Freeze. If one is to be undertaken two classes of shares are often required:

- **Preferred voting shares** are issued to the person whose estate is to be frozen in return for assets transferred to the corporation. These shares will not change in value.

- **Common shares** are issued to the children and the spouse. Common shares will receive the future growth of the corporation.

Separation of ownership, control and division of profit: Several classes of shares may be issued. For example:

- **Preferred non-voting shares** may be issued to the individuals transferring assets to the corporation.

- **Class A common voting shares** may be issued to those shareholders who are given control, rights to dividends, and rights to share in the future growth of the company.

- **Class B common non-voting shares** are issued to those shareholders who are given rights to dividends (and often future growth as well), but no control as far as voting is concerned.

Split income between spouses: The following share structure may be selected:

- **Preferred non-voting shares** are issued to the person transferring assets.

- **Common voting shares** are issued to the husband and wife in the same proportion as they decide to divide dividend income.

Often two different classes of common voting shares are issued (one class to each spouse) to facilitate income splitting. This may result in being able to have different amounts of dividends to the different classes of shares.

If a dividend is declared on one class of shares, all holders of that class must receive the dividend. If you want each spouse to have a different amount of dividends, they would require different classes of shares.

When shares are issued to the lower income spouse, the following points should be kept in mind:

- The shares should be issued by the corporation to the lower income spouse.

- The lower income spouse should pay for the shares from his/her own source of capital. If the capital to pay for the shares originated with the higher income spouse, then for taxation purposes the earnings on the shares are deemed to be the higher income spouse's. In this case, capital gain on the shares or dividends would be taxed as the higher income spouse's income (at a higher rate of tax).

If the lower income spouse does not have his/her own funds, and since shares are issued at a nominal value, s/he could easily borrow the money on a short-term basis from a bank.

Under the attribution rules of the Income Tax Act, shares that are given by a parent to a minor child result in dividends (but not capital gain) being taxable in the hands of the parent up to the time the child turns 18 years of age. After that time both capital gain and dividends would be taxable in the hands of the child.

Normally, it is not advisable to transfer or give shares to a minor child directly since they are unable to deal with the shares (trusts are often used in this case). In addition, by the time the child reaches maturity, the capital represented by the shares could be quite large.

Note that many of these share structures are very complex and require expert advice to ensure that the desired benefits are achieved.

Transfer of Assets to a Corporation

Existing farms may have assets comprised of land, buildings, improvements, equipment, livestock, grain, feed and supply inventories, personal property or cash. In addition, there may be liabilities or other charges against the assets.

At the time of incorporation, the shareholders decide on what assets and liabilities will be taken over by the corporation and how the transfer of assets will be financed. The main considerations in transferring assets to the corporation is the income tax effect on the individual and corporation and the degree of flexibility desired in handling assets.

The initial step in deciding what assets to transfer and at what value is to determine the relevant values. List each asset and establish the current fair market value and the cost at the date of purchase. If the property was owned on December 31, 1971 the Valuation Day value is required. The undepreciated capital cost (tax value) is also required for depreciable property.

Individuals should attempt to justify these values in the event of a dispute with Revenue Canada. In valuing real estate, data on comparable sales is ideal. Alternatively, an appraiser could be hired to establish values.

Section 85 of the Income Tax Act permits a taxpayer to transfer assets to a corporation on a capital gain rollover, thereby deferring income tax to a later time. The rollover is permitted only in certain circumstances and if specific procedures are followed.

The various types, or classes of assets that may be transferred to a corporation are classified as land, principal residence, Part XI depreciable assets, Part XVII depreciable assets, inventories (marketable grain, livestock and farm supplies) and basic herds.

The various alternatives for handling these assets are discussed in the following paragraphs.

Alternatives for Land

Rollover of land to the corporation: For capital gains purposes, a transfer value can be elected anywhere between the fair market value of land at the time of transfer and the tax cost, to a minimum of the non-share consideration received for the land. Consideration may be cash, shareholder's loan, an agreement for sale or some other debt instrument.

When this provision is used, it is common to have the land transferor receive consideration equal to the adjusted cost base (tax cost) of the land. Then the value elected is equal to the consideration which is also the adjusted cost base. No capital gains are realized by the transferor.

At the same time preferred shares equal in value to the difference between the fair market value of land and the consideration received are issued to the land transferor. It is suggested that the preferred shares be retractable and redeemable. This means that the shares may be redeemed at the option of either the corporation or the shareholder.

The purpose of this approach is to attempt to maintain the preferred shares at the value at the time of issue. Section 85 of the Income Tax Act provides that such preferred shares would have a reduction in paid up capital equal to the difference between the fair market value of the land and the elected transfer amount (i.e., the amount of capital gain deferred).

The following example illustrates the above procedure.

Land	- Fair market value	$100,000
	- Adjusted cost base	20,000
	- Consideration received on transfer to corporation	20,000
	- Elected transfer value	20,000*

* The elected transfer value may not exceed the fair market value or be less than the consideration received.

Capital gain to transferor =	
Elected transfer value	$20,000
Adjusted cost base	20,000
Capital gain	Nil

80,000 preferred shares (redeemable at the option of the company or shareholder) are issued at $1.00 per share. This amount is equal to the difference between the fair market value of the land and the consideration received ($100,000 - $20,000 = $80,000). The paid-up capital of these shares is reduced by $80,000 in total, leaving paid-up capital of $80,000 - $80,000 = nil.

For taxation purposes, the transferor and the corporation must file form T2057 with Revenue Canada, on which they elect a transfer value for the land ($20,000 in the above example). The adjusted cost base of the land to the corporation is equal to the elected amount. A subsequent sale of the land at market value would result in a capital gain to the corporation equal to the amount by which the fair market value exceeds the $20,000 adjusted cost base.

For accounting purposes, the land will appear on the corporation's balance sheet with a value equal to the sum of the consideration paid plus the value of the redeemable retractable preferred shares issued. In the above example, the land would have a value of $100,000 on the balance sheet.

The land transferor who receives the redeemable retractable preferred shares is, for taxation purposes, deemed to have acquired them with an adjusted cost base of zero in this example. The subsequent sale of these shares at market value would result in a capital gain ($80,000 in this example). The Capital Gains Exemption may be used to offset the capital gain. However, alternative minimum tax may apply.

Further, if the corporation were to redeem the preferred shares, (assuming that they were issued after November 21, 1985) under Section 85, a deemed dividend would result, rather than a capital gain for taxation purposes. Deemed dividends are not eligible for the lifetime Capital Gains Exemption.

Potentially, the land in the corporation and the preferred shares of the shareholder, if transferred or sold to another party, could be subject to capital gain, thereby generating a double tax liability for the same basic gain.

However, since the preferred shares, in most cases, can be rolled over to family members this problem is not likely to occur. For further discussion, see the section entitled "Share Transfers and Reorganization".

Preferred shares issued under a Section 85 rollover should pay a reasonable rate of dividends to the shareholder. The dividends should be payable annually and the shareholder should not be able to waive the rights to dividends. The payment of dividends on Section 85 preferred shares avoids unnecessary taxation of deemed benefits. This is more important in corporations with more than one shareholder than if there is only one shareholder.

Given the complexity of a Section 85 rollover one should generally consult an accountant for help with the planning and then the filing of all required documentation.

Implications of this option:

- Money received for the consideration up to the adjusted cost base of the transferred land is free of tax to the individual.

- Capital gain may be deferred.

- Land "value" is frozen. Future increase in value can be transferred to other family members depending on the share structure.

- A capital gain rollover may apply to share transfers to future generations.

- Capital gain tax liability when the shares are sold at market value. However, the Capital Gains Exemption may offset this.

- Capital gain tax liability to the corporation if it sells the land (no capital gains exemption for corporations).

- Potential tax liability if the corporation is dissolved.

- Deemed dividend treatment if corporation redeems Section 85 preferred shares.

- Cannot transfer the land back to the shareholders without a tax liability to the corporation.

- Loss of direct control of the land.

Land is sold to the corporation: Land could be transferred to the corporation by selling it at fair market value. This results in a capital gain to the land transferor equal to the difference between the selling price (fair market value) and the adjusted cost base. The capital gain for the transferor could be offset using the $500,000 Capital Gains Exemption. The corporation then has a higher cost base on the land and will result in less capital gain if the corporation ever sells land or transfers it back to the shareholders. However, alternative minimum tax may apply.

If the land transferor sells the land on an agreement for sale or takes back a mortgage on the land, up to a five year capital gain reserve can be created for the principal unpaid providing the individual transferring the land has less than 50% of the voting shares. This will allow alternative minimum tax averaging over a five year period. In order to have the right to claim the reserve, there must be a stated repayment schedule. (The principal unpaid must not be payable on demand.)

It should be noted that in many cases, any Alternative Minimum Tax paid in one year is recoverable over the next seven years (assuming that there are not large deductions every year). In addition, it should be remembered that, in Saskatchewan, even with the capital gains exemption, there is still the 2% (of the taxable capital gain) provincial flat tax.

Implications of this option:

- A portion of the money received is free of tax to the individual. The total amount of consideration which may be withdrawn tax-fee is greater with this option than with a Section 85 rollover. Under a Section 85 rollover, the tax-free amount is limited to the adjusted cost base of the land. Under this option it is the fair market value of the land. However, there may be tax on the taxable capital gain if the total capital gain exceeds the $500,000 Capital Gains Exemption. Therefore, a combination of this option and the previous option may be the best approach.

- The land "value" is frozen as in a Section 85 rollover but at fair market value.

- Problems in dealing with preferred shares issued on the transfer of land are avoided or reduced.

- The future tax liability of the corporation for future capital gains is reduced if the land is sold after incorporation or the corporation is subsequently dissolved and assets are transferred back to the shareholders.

- A capital gain rollover may apply to share transfers to future generations. Any unused portion of the lifetime Capital Gains Exemption may also be used on the share transfer.

- The land transferor will incur capital gain on the transfer of land to the corporation but may be eligible to use the $500,000 Capital Gains Exemption.

- Alternative minimum tax may apply.

- Provincial flat tax will apply.

- Loss of direct control of the land.

Land is leased to the corporation: Rather than transfer the land to the corporation, the individual could continue to hold it personally. Then the individual would lease the land to the corporation and receive a cash or crop share rent. Individuals may wish to retain ownership of land rather than transfer it to a corporation. Since 1984, farm land

leased by a taxpayer to his family farm corporation or to his spouse's or child's family farm corporation will qualify for a rollover to a child.

It is possible for a corporation to pay a nominal rent for assets leased by a shareholder to a corporation. Providing the rent received by the shareholder offsets the expense he reports for income tax purposes, Revenue Canada will not likely challenge the amount of rent paid.

Normally it is preferable to have the corporation receive as much income as possible and retain the earnings. If the landowner receives a fair market rent, then much of the taxation benefits of incorporation may be lost. However, the individual likely needs at least some earnings to provide money for personal living expenses, so the restriction may not be that significant.

An additional benefit of keeping the land owned personally (rather than by the corporation) is the possibility of protecting the land from creditors of the corporation.

Implications of this option:

- Land ownership is retained by the individual. There is more flexibility in dealing with land in the future.
- If the corporation were dissolved, the legal and tax costs of dissolution would be relatively low.
- Land leased to a family farm corporation will qualify for a rollover to a child.
- By paying rent, part of the income tax advantage of incorporation is lost because of reduced flexibility in the type and amount of income to be received.
- Land "value" is not frozen.
- More complex procedure when borrowing money.
- Possible creditor protection.
- More accounting and administration.

Land continued to be owned and operated by the shareholder: The shareholder-landowner would retain the title to some or all of the land in his name. Some or all of the machinery would be transferred to the corporation.

The land owned individually would be farmed separately from the corporation with individually owned machinery, or corporation machinery would be hired on a custom basis. This technique is much the same as leasing land to the corporation. However, the individual (not the corporation) would still farm the land.

A large portion of the income generated from the land would therefore bypass the corporation and go directly to the individual shareholder with a resulting reduction of the income tax advantage of incorporation.

Implications of this option:

- If the corporation provides only custom work, it may not qualify as a family farm corporation, but it may qualify as a small business corporation (both of which qualify for the $500,000 capital gain exemption, but only farm corporations can be rolled over to children).
- The capital gain rollover on the transfer of farmland from a parent to a child is maintained.
- Land ownership is retained by the individual. There is more flexibility in dealing with the land in the future.

- If the corporation was dissolved, the legal and tax costs of dissolution would be relatively low.

- The income tax provisions for a principal residence are maintained.

- The individual has the status of a farmer and can use the Investment Tax Credit against federal income tax payable on personal income.

- A major portion of the income from the land bypasses the corporation and goes directly to the shareholder. A significant tax advantage of incorporating may be lost.

- Land "value" is not frozen.

- More complex procedure when borrowing money.

- More accounting and administration.

The corporation and individual operate under a farm operating agreement: Initially, some assets such as machinery, land, buildings or livestock may be transferred to the corporation while the individual retains ownership of most of the asset base. The individual and corporation operate the combined farm unit under a farm operating agreement whereby the income and expenses are shared according to the relative contributions of the two parties.

The acquisition of future assets can be made by the individual or the corporation, whichever is more advantageous.

Implications of this option:

- As the individual retains status as a farmer, the rollover provisions for land, buildings and machinery to a child are maintained.

- There is more flexibility in dealing with land in the future.

- The operation is flexible to permit change to most advantageously conform to changing income tax and other government regulations.

- Capital asset acquisitions can be made by either the individual or the corporation.

- As not all the income is initially received by the corporation, part of the income tax advantage of incorporation may be lost.

- More complex procedure when money is borrowed.

- There is much more accounting and administration.

In summary, there are advantages to holding the land inside or outside of the corporation. If held personally, the greatest flexibility is maintained. If the land is held inside the corporation, it may be easier to manage along the way, but care must be taken to properly plan for its disposition.

If the land is to be held in the corporation, it appears that the best option is to transfer land to the corporation at fair market value and have the transferor offset the gain with the $500,000 Capital Gains Exemption. Planning around the alternative minimum tax rules would be necessary. The second best alternative would be to transfer the land to the corporation using the Section 85 rollover. A combination may be best if the capital gain would exceed the $500,000 capital gain exemption available.

Land may be leased to or custom work hired from the corporation when the shareholders wish to experiment with the corporate structure before making a full commitment. Later if a long range commitment is evident the land could be transferred to the corporation.

When transferring title to land from an individual to a corporation substantial land titles and legal fees occur. A method of deferring payment of these fees is to sell the land to the corporation on an agreement for sale whereby title to the land does not pass to the corporation until the last dollar is paid. As long as one dollar is unpaid, the transfer fees could be postponed indefinitely.

Note: The lifetime Capital Gains Exemption is available for real property (land and permanent buildings), eligible capital property, shares in a family farm corporation or an interest in a family farm partnership. Thus machinery and buildings not permanently affixed to the land are not eligible. However, where such buildings and machinery are owned by a family farm corporation or partnership, the value of these assets is reflected in the value of the shares or the partnership interest. Thus capital gains (and recaptured capital cost allowance) on these assets effectively qualify for the lifetime Capital Gains Exemption - if the shares are sold (rather than the individual assets).

Principal Residence

Only individual taxpayers qualify for the principal residence exemption. Corporations do not. At the time of incorporation, the individual may transfer the personal portion of his principal residence tax free to the corporation. However, the house owned by the corporation would be subject to capital gain if the house were sold at an increased value in the future. If the house owned by the corporation is personally used by one of the shareholders, the shareholder must pay a reasonable rent or be deemed to receive a taxable benefit.

Normally, it is best for the owner to continue to own the principal residence, since it will be exempt from capital gain when transferred. Often, however, the principal residence may be located on a piece of land which is transferred to the corporation. If the land is to be transferred to the corporation, the following two alternatives exist:

- A long-term leasehold agreement can be prepared which gives the owner of the house the right of access and the use of the house and a small area around it.

- The house owner could apply to the rural municipality to subdivide a small acreage on which the house is situated on the quarter section. This is usually the preferred approach.

Alternatives for Part XI Depreciable Assets (Diminishing Balance)

Part XI depreciable assets most often include machinery and buildings purchased after December 31, 1971. The options for Part XI depreciable assets are as follows:

Sale to the corporation at fair market value: Special income tax rules apply when Part XI assets are sold or transferred by an individual or partnership to a corporation when the parties do not deal at arms length. If the corporation pays less than the shareholder's original capital cost, the capital cost to the corporation is deemed to be equal to the shareholder's cost. The difference is deemed to be capital cost allowance previously claimed by the corporation.

Example: An individual purchased a tractor for $30,000. It is subsequently sold by the shareholder to a corporation for $20,000. The corporation would have a deemed cost for the tractor of $30,000 and would add $20,000 to the capital cost allowance schedule. The shareholder would report $20,000 as proceeds of disposal.

Special rules also apply when a corporation purchases Part XI assets from a shareholder in a non arms length transaction for an amount which exceeds the shareholder's capital cost. If the shareholder reports a capital gain that is offset by a capital gains exemption then the corporation must reduce its capital cost to an amount equal to the shareholder's original capital cost.

Example: An individual purchased a building for $30,000. It is subsequently sold to a corporation for $35,000. The individual reports a capital gain of $5,000 which is offset with a $5,000 capital gains exemption. The corporation has a deemed capital cost of $30,000 and adds $30,000 to the capital cost allowance schedule. The shareholder would show proceeds of disposal from his capital cost allowance schedule of $30,000.

Buildings cannot be transferred at less than the undepreciated capital cost. Special rules exist for determining the deemed proceeds of a building.

Implications of this option:

- The corporation has a higher capital cost allowance base.
- There is no tax averaging provision available to the individual to handle recaptured capital cost allowance.
- High immediate tax cost because of recaptured capital cost allowance and possible capital gain to the individual.
- Lower tax cost to the corporation if it is dissolved.

Rollover to the corporation: With this election, a transfer value is selected that is anywhere between the fair market value of the assets and the consideration other than shares received for the assets. The most common situation is where non-share consideration is received for an amount equal to the undepreciated capital cost of the assets, therefore, recaptured capital cost allowance does not occur. At the same time preferred shares equal in value to the difference between the fair market value of the asset and the non-share consideration received (undepreciated capital cost) are issued to the transferor. As with rollovers of land, the preferred shares should pay a reasonable dividend. The corporation acquires the assets with the same undepreciated capital cost and original costs as the transferor.

Implications of this option:

- There is no immediate tax cost to either the individual or the corporation.
- When the assets are subsequently sold, the recaptured capital cost allowance will be taxed in the corporation rather than in the individual's hands. This should be at a lower tax rate.
- A rollover to future generations is permitted on the shares received for the assets transferred to the corporation.
- Deemed dividend treatment if Section 85 preferred shares are redeemed by the corporation.
- Larger tax liability if the corporation is dissolved.
- Accounting costs to do the rollover.

Shareholder continues to own the assets: Some or all of the machinery or buildings may be retained by the shareholders rather than transferring them to the corporation. This technique may be used when a great deal of flexibility is desired and the shareholders believe that the corporation may last only a short period of time.

With this technique a much larger amount of income must be received as rental income directly by the shareholders. As the tax advantages of incorporation are greatest when the income is routed through the corporation and then retained by the corporation, much of the tax advantages of incorporation may be lost.

In summary, except in special circumstances, a Section 85 rollover of assets is usually best for Part XI depreciable assets.

Buildings require special consideration. If the land on which the buildings are located is transferred to the corporation, then it is normally preferable to transfer the buildings as well. However, if the land on which the buildings are located is not transferred, but the intention is to transfer the buildings, then the following three alternatives exist:

- A long-term leasehold agreement can be prepared which gives the corporation as the building owner the right to access and the use of the buildings and a small area around them.

- The corporation could attempt to obtain a subdivision for the land on which the buildings are situated.

- The buildings are sold with the right of access and removal.

Part XVII Depreciable Assets (Straight Line)

The Part XVII method of capital cost allowance applies to machinery and buildings acquired prior to January 1, 1972 by farmers who used that method.

If these assets are transferred to the corporation, they must be transferred at their fair market value. There is no recaptured capital cost allowance for Part XVII assets; however, a capital gain will occur if the fair market value exceeds the adjusted cost base (original cost or fair market value on valuation day). The $500,000 capital gain exemption may be available.

Alternatives for Inventory

For taxation purposes, the term inventory includes all current assets that would be income when sold. Specifically, inventory will include grain, feed, livestock, and all farm supplies (fertilizer, chemicals, etc.) Grain held on a storage ticket at an elevator company is inventory. However, grain sold on a deferred cash ticket or grain delivered to an elevator with an authorization to ship is not inventory.

The following alternatives exist in handling inventory:

Inventory sold through normal channels: The inventory that is sold becomes income to the farmer for taxation purposes. If the farmer is in a high tax bracket, a large tax liability may arise. Implications of this option:

- The tax liability is small if the total value of the inventory is low and the farmer is in a low tax bracket.

- The tax liability may be high if the total value of this inventory is high and the farmer is in a high tax bracket.

Inventory sold to the corporation: The inventory is sold to the corporation at its fair market value on a promissory note and it is agreed between the corporation and the transferor that the amount will be payable over time. The transferor will report the income only as payments are received from the corporation. The corporation may claim expenses only as payments on the note are made to the transferor.

Implications of this option:

- Operating capital is not tied up in an off-farm source.

- Income tax is averaged for the individual over a longer term.

- Some degree of flexibility in repaying the note.

- There is no accrued tax liability to the corporation or individual.

- The individual will likely have to pay income tax over the term of the note.

Inventory is rolled over to the corporation: Inventory can be rolled to the corporation at the lesser of cost or consideration (other than shares) received although a higher value can be elected if desired. For farms on the cash basis of accounting, the cost of inventory is deemed to be zero. Therefore, the inventory could be transferred to the corporation for $1.00 if no consideration is received, other than shares. Preferred shares are issued to the transferor for the difference between the elected value and the fair market value of the inventory. The preferred shares should pay a reasonable dividend to the shareholders.

The transferor will not be subject to any tax on the inventory transferred (technically, there would be tax on the $1). The preferred shares, if sold at market value or transferred to another party, would result in a capital gain. The $500,000 Capital Gains Exemption may be used to offset this amount. However, if the preferred shares are redeemed by the corporation their value will be a deemed dividend to the shareholder rather than a capital gain. Preferred shares issued under Section 85 rollovers after November 21, 1985 result in deemed dividends and are not eligible for the lifetime Capital Gains Exemption. The preferred shares also remain eligible for rollover provisions.

The inventory transferred to the corporation will become taxable income as it is sold by the corporation.

Implications of this option:

- The corporation is placed in a strong working capital position.

- Income taxes are minimized.

- For the individual, potential taxable income (inventory) is converted to potential capital gains or deemed dividends (preferred shares).

- Preferred shares may be rolled over to children thereby deferring tax for a longer period.

- Transferor receives no immediate cash for his inventory.

- Tax liability of the preferred shares if sold at market value. However, they would qualify for the Capital Gains Exemption. If the preferred shares are redeemed by the corporation, a deemed dividend occurs which is not eligible for the Capital Gains Exemption.

- The corporation has no offsetting expenses for the income realized when the inventory is sold other than the current year's operating expenses.

Basic Herd

The basic herd owner may transfer his livestock to the corporation and deduct from the proceeds the value of the basic herd animals on Valuation Day (December 31, 1971). The basic herd is treated as normal purchased livestock inventory in the hands of the corporation.

Liabilities

Some or all of the debts of the farmer may be assumed by the corporation. Normally, the assumption of a debt is part of the non-share consideration received.

Note: When assets are transferred to a corporation using a Section 85 rollover, the elected transfer amount cannot be less than the consideration received. Debts assumed by the corporation on such a transfer are part of the consideration received. Therefore, the elected transfer amount

cannot be less than the debts assumed by the corporation on the specific assets.

Deemed Gifts

The full value of assets transferred to a corporation must be accounted for by way of consideration including shares. If this is not the case, the amount not accounted for may be considered a gift conferred on other shareholder, if any, of the corporation.

If a farmer sold land to a corporation that was worth $200,000, took back a note for $50,000 and 50 shares were issued to each of the husband and wife, then in effect there would be a deemed gift to the wife of one half of $150,000 or $75,000.

The deemed gift would be avoided if the husband received $150,000 in preferred shares in addition to the $50,000 note.

The amount of any gift conferred to other shareholders is added to the elected transfer of value of assets for the determination of capital gain.

The following example illustrates a common method of transferring assets to a corporation.

Assets	Fair Market Value	Debt	Adjusted Cost Base or Undepreciated Capital Cost	Cash or Notes	Debts Assumed	Preferred Shares	Total
Land	$600,000	$100,000	$200,000	$500,000	$100,000		$600,000
Principal Residence - principal residence is not transferred to corporation							
Part XI Assets including Business portion of Principal Residence	100,000	20,000	60,000	40,000	20,000	$40,000	100,000
Part XVII Assets	10,000	0	15,000	10,000	0	0	10,000
Inventory	100,000	0	0	0	0	100,000	100,000
	$810,000	$120,000		$550,000	$120,000	$140,000	$810,000

In this example, there would be no tax payable (except for Saskatchewan Flat Tax on the taxable capital gain, and possibly some alternative minimum tax). The land is transferred at fair market value ($600,000) in order to permit the shareholder to utilize his Capital Gains Exemption. The principal residence is retained personally. The Part XVII assets are transferred at fair market value. The inventory and Part XI assets are rolled over under Section 85 of the Income Tax Act. Preferred shares are issued with a value of $140,000 to reflect the value rolled over to the corporation. The preferred shares should be retractable and redeemable. An annual dividend should be paid on the shares. If the preferred shares were sold at market value the shareholder would have a capital gain of $140,000. However, shares in a family farm corporation may be rolled over from a parent to a child. Preferred shares qualify for this rollover. If the preferred shares were redeemed by the corporation there would be a deemed dividend to the shareholder.

Debts assumed by the corporation are part of the consideration received. In certain situations this may result in a tax liability to the transferor. For example, if cattle with a debt of say $100,000 were transferred to the corporation and the corporation assumed the $100,000 debt, the individual would have received $100,000 of taxable income.

Assets transferred at fair market value such as land could be transferred over a five year period using an agreement for sale. This would minimize the impact of minimum tax if the transferor did not have voting control of the corporation.

Operation of a Corporation

The operation of an incorporated business is more complex than a sole proprietorship. Certain rules and procedures must be followed. Taxation considerations are also more complex.

Taxation of Corporate Income

In Saskatchewan, a corporation that qualifies as a Canadian controlled private corporation is taxed at a flat rate of approximately 21.12% on active business income up to $200,000 earned in one year. Note that this rate is increased for corporations having taxable capital employed in Canada of between $10,000,000 and $15,000,000 and becomes the full rate for corporations exceeding $15,000,000 of taxable capital. If taxable income in the year exceeds $200,000, the tax rate is approximately 46.12% on these excess amounts.

Most Saskatchewan farm corporations qualify for the 21.12% tax rate as long as the corporation is controlled by Canadians and it is not a public company.

Active business income that qualifies for the 21.12% rate would include earnings from farming as well as interest earned on short-term deposits (if these deposits are kept for farming purposes). Other types of investment income such as interest earned on long-term investments, and taxable capital gains are referred to as non-active business income and would be subject to a 52.79% tax rate. However, if these types of income were paid out as dividends a tax credit of 25% would be earned by the corporation thereby reducing the effective rate to 27.79%.

The following example illustrates the corporate tax on farm earnings.

Net Farm Income (Taxable Income)	$50,000
Corporate Tax (21.12%)	10,560
Corporate Earnings After Tax	$39,440

Taxation of Dividends

Corporations may retain their earnings after paying income tax or pay dividends to the shareholders. Retained earnings are a form of tax shelter until they are paid out as dividends.

Any portion of a corporation's after tax earnings may be paid to the shareholders as dividends. The following example indicates a situation where all the earnings are paid out as dividends.

Corporate Earnings After Tax	$39,440
Dividends Paid	39,440
Retained Earnings	0

Shareholders who receive corporate dividends must report the dividends on their income tax return, but are able to claim a dividend tax credit. The dividend tax credit is used to prevent double taxation of earnings, since the corporation has already paid income tax on its profits.

The following example illustrates how dividends are taxed based on a cash dividend of $39,440. (See previous example.)

Cash Dividend Received	$39,440
Gross Up (25%)	+ 9,860
Taxable Amount of Dividend	$49,300
Federal Income Tax Calculation	$10,155
Dividend Tax Credit (13.33% of Taxable Amount of Dividend)	- 6,573
Non-Refundable Tax Credits	- 1,098
Basic Federal Tax	$ 2,484
Individual Surtax	+ 74
Provincial Income Tax	+ 2,301
Total Tax Payable	$ 4,859

Shareholders who receive dividends must gross up the actual cash dividend by 25% to determine the taxable amount of the dividend. The shareholder may then claim a dividend tax credit equal to 13.33% of the taxable amount of the dividend. Since the dividend tax credit reduces the Basic Federal Tax and Provincial Income Tax is calculated on the Basic Federal Tax, a dividend tax credit reduces both federal and provincial tax payable.

The Saskatchewan Flat Tax of 2%, however, is calculated on the taxpayer's net income (taxable amount of dividend in the above example), consequently, the dividend tax credit does not reduce this tax.

The total income tax payable by the corporation and the individual in the above examples is ($10,560 + 4,859) = $15,419. Had the individual earned $50,000 from an unincorporated business the personal income tax on that amount would be $17,074. Routing income through a corporation then back to the individuals as dividends results in a small income tax savings. In addition, tax deferral occurs by leaving the retained earnings in

the corporation, but this tax shelter is lost when dividends are paid. Over time, this tax deferral is a very significant benefit. For further discussion see the section entitled "Income Tax Benefits of Incorporation".

Taxation of Non-Active Business Income and Dividends Received by a Corporation

Non-active business income is taxed at 52.79% in Saskatchewan. However, if a dividend is paid out to shareholders the corporation is entitled to a 25% Refundable Dividend Tax Credit which in effect reduces the actual rate to 27.79%.

Dividends received by a corporation are subject to a tax rate of 33.33%. However, an offsetting tax credit of 33.33% applies if the dividends are paid out to shareholders. This means that dividends can flow into a corporation and back out to shareholders and result in the same level of tax payable as if the shareholder had received the dividends directly.

Taxation of Capital Gain in a Corporation

Three-quarters of a capital gain received by a corporation is taxable at a flat 52.79% rate. The other one-quarter is tax free. The tax free portion of the capital gain may be paid out to shareholders as a tax free dividend.

The refundable tax credit of 25% is available to the corporation if the taxable portion of the capital gain is paid out to the shareholders. This would result in an effective tax rate of 27.79% on the taxable portion.

Loans to Shareholders

Taxation policy dealing with loans made by a corporation to a shareholder are very restrictive and specific.

Loans made by a corporation to a shareholder that remain unpaid at the end of the year following the year in which the loan is made will be income to the shareholder. Loans between a corporation and shareholder should be properly documented.

A shareholder who receives a low interest rate loan from a corporation will be deemed to receive a taxable benefit. This occurs if the interest rate charged is less than the prescribed rate. The prescribed rate of interest is set by Revenue Canada every three months. It is based on 90 day treasury bill interest rates.

Taxable Benefits

Employees or shareholders who receive benefits such as personal use of a company car or house, or low or no interest loans are deemed to receive a taxable benefit that must be reported by the individual as income. A standby charge must be reported as income by the shareholder or employee for use of a company car. Generally, a shareholder/employee should not use company vehicles for personal use as the standby charge creates significant tax liabilities. If the same vehicle is used for both farm and personal use, it is often advisable to own the vehicle personally and have the corporation pay a reasonable mileage expense reimbursement. Revenue Canada has indicated that 33 cents for the first 5,000 kilometres and 27 cents thereafter would be reasonable for 1996, and 35 and 29 cents respectively for 1997.

Income Splitting

As an individual's taxable income increases, it is taxed at ever increasing rates. This is known as a progressive tax system. Because of this, lower amounts of income tax are paid by a family unit if the total income can be divided between two or more people (say a husband and wife) than if all the income was received by one person (the husband). Income splitting is a tax management

technique which is used to lower the amount of income tax payable.

Prior to the 1980 taxation year a farmer was unable to claim wages paid to his/her spouse as an expense. Only incorporated farms were able to achieve income splitting by paying wages to both a husband and a wife. Beginning January 1, 1980 proprietorships may also pay wages to a spouse and claim the amount as an expense. The amount of wages paid to a spouse must be reasonable for the type and amount of work actually performed. Corporations and proprietorships are now in the same position with regard to the payment of wages to a spouse.

However, corporations do offer further income splitting opportunities. A spouse may purchase shares in a corporation. To the extent that dividends are paid, further income splitting is possible between a husband and wife in addition to the payment of wages. To achieve this it is important for the lower income spouse to purchase the corporations shares with his/her own source of money.

Registered Pension Plans and Registered Retirement Savings Plans

A farm corporation may set up a registered pension plan for its employees. Registered pension plans are quite expensive to set up and maintain, so most small family farmers would use the Registered Retirement Savings Plan (RRSP).

Taxpayers may make contributions to a Registered Retirement Savings Plan subject to a limit of 18% of the previous years "earned income", to a maximum of $13,500. Interest and dividends received by a shareholder are not earned income for the purposes of purchasing a registered retirement savings plan. Rental income, wages and salaries would be considered as earned income for these purposes.

Canada Pension Plan

After a farm is incorporated, the amount of Canada Pension Plan contributions will relate to the salaries and wages paid to each employee. If part of the farm continued to be operated as a proprietorship then Canada Pension Plan contributions could also be made on those earnings subject to the yearly maximum. When wages are paid, the employer (corporation) must match the employee's contributions. In a proprietorship, the farmer makes the full contribution (both employee and employer portions) directly.

Deferred Profit Sharing Plans

A corporation may establish a deferred profit sharing plan for its employees. However, contributions to a deferred profit sharing plan for a shareholder-employee of the corporation is now prohibited. The value of deferred profit sharing plans for most farm corporations is very limited.

Tax Installments

A corporation is required to make quarterly tax installments to Revenue Canada. The installments are based on either the previous year's income tax paid or an estimate of the current year.

Individual farmers are required to make tax installments to Revenue Canada by December 31st, calculated as 2/3 of the individual's instalment based for the preceding taxation year.

Fiscal Year

When a corporation commences operations it can select any fiscal year end that it finds most suitable. The first fiscal year need not include a full 12 month period. For example, the first year may be only seven months. Often it is desirable to end the first fiscal year just before the company begins to realize taxable income, then begin the new fiscal year. This defers the payment of tax for 12

additional months, subject to the required tax installments.

Income Tax Filing

A corporation must file an income tax return (T-2) within six months of the fiscal year end. It should be noted, however, that the final amount of tax owing must be paid within three months of the fiscal year end. The corporation must include a balance sheet and profit and loss statement along with its tax return.

In addition it must issue employee T-4 slips (for employment income paid) and T-5's (statements of investment income (dividends and interest) paid out) by the end of February each year.

Individuals must file tax returns on a calendar year basis by April 30 of the following year if income tax is payable, a refund is claimed or if requested to do so by Revenue Canada.

Income Tax Benefits of Incorporation

Farms with high levels of net income, an objective of increasing farm size, and/or with a high level of debt may achieve tax benefits by incorporating. The benefits are chiefly in the form of tax deferral rather than as tax savings. Individuals considering incorporation should calculate their tax position based on their set of circumstances to determine if benefits will occur. The following examples and tables provide a basis for these calculations.

Assumptions:

- One shareholder corporation.
- 1996 tax rates are used.
- Net income is gross income less operating costs and capital cost allowance.
- Net income is assumed to be $50,000.
- Non-refundable tax credits $1,401 (self, and C.P.P.) or $1,249 for an employee.
- Canada Pension Plan Contribution is 2.8% (5.6% if self-employed) of pensionable earnings less $3,500 exemption. Maximum contribution is $893 for an individual employed and $1,786 for a self-employed individual when pensionable earnings equal or exceed $35,400.

Situation A

Sole Proprietorship	
Total Income (also Taxable Income)	$50,000
Federal Tax Calculation	10,337
Non-refundable Tax Credits	- 1,401
Basic Federal Tax	$ 8,936
Federal Surtax	+ 268
Provincial Income Tax	+ 6,085
Total Income Tax Payable	$ 15,289

Situation B

Corporation: A basic wage of $35,400 is paid to the shareholder. Dividends equal to the corporate after tax income are also paid. Therefore, retained earnings are zero.

Company	
Net Income (before wages)	$50,000
Wages	-35,400
Canada Pension Plan	- 893
Corporate Taxable Income	$ 13,707
Corporate Income Tax at 21.12%	- 2,895
Corporate After Tax Income	$ 10,812
Dividend Paid	-10,812
Retained Earnings	$ 0

Individual	
Wages	$35,400
+ Cash Dividend	+10,812
+ Gross Up Amount	+ 2,703
Net Income (also Taxable Income)	$ 48,915
Federal Income Tax	$ 10,054
Dividend Tax Credit	- 1,802
Non-refundable Tax Credits	- 1,249
Basic Federal Tax	$ 7,003
Federal Surtax	+ 210
Provincial Income Tax	+ 4,850
Total Income Tax Payable	$12,063

Total Income Tax Payable = $2,895 + $12,063 = $14,958.

Situation C

Corporation: The objective is to maximize retained earnings in the corporation in order to obtain the greatest income tax advantage. A basic wage of $35,400 is paid to maximize contributions to the Canada Pension Plan. These amounts are assumed to meet the shareholders living and income tax requirements.

Company	
Net Income (before wages)	$50,000
Wages	-35,400
Canada Pension Plan	- 893
Corporate Taxable Income	$13,707
Corporate Income Tax at 21.12%	- 2,895
Corporate After Tax Income	$10,812

Individual Wages:	
Net Income (also Taxable Income)	$35,400
Federal Income Tax	$ 6,540
Non-refundable Tax Credits	- 1,249
Basic Federal Tax	$ 5,291
Federal Surtax	+ 159
Provincial Income Tax	+ 3,539
Total Tax Payable	$ 8,989

Total Income Tax Payable = $2,895 + $8,989 = $11,884

Total Corporate and Personal Income Tax Payable
at Various Net Income Levels - One Person

Net Income	$40,000	$50,000	$75,000	$100,000
Situation A				
Sole Proprietorship				
- Tax Payable	$10,740	$15,289	$27,628	$40,614
Situation B				
Corporation				
(Pay Dividends)				
- Wages	$35,400	$35,400	$35,400	$35,400
- Dividend (cash portion)	2,924	10,812	30,532	50,252
- Retained Earnings	0	0	0	0
- Tax Payable	$10,584	$14,958	$26,737	$39,121
Situation C				
Corporation				
(Max. Retained Earnings)				
- Wages	$35,400	$35,400	$35,400	$35,400
- Retained Earnings	2,924	10,812	30,532	50,252
- Tax Payable	$ 9,772	$11,884	$17,164	$22,444
Tax Savings (A compared to B)	$ 156	$ 331	$ 891	$ 1,493
Tax Deferral (A compared to C)	$ 968	$ 3,405	$10,464	$18,170

A comparison of the income tax payable for levels of net income other than $50,000 is contained in the previous table and Figure 1. The assumptions and calculations are the same as in the previous example.

The table illustrates that there is very little tax savings by establishing a corporation and paying the profits out as dividends (Situation B) as compared to receiving the same income as a proprietorship (Situation A).

Large tax deferral benefits occur at higher levels of net income when a corporation attempts to maximize its retained earnings (Situation C) as compared to a proprietorship (Situation A). The tax deferral is small at low levels of retained earnings ($968 at $40,000 net income) and significant at high levels of retained earnings ($18,170 at $100,000 net income).

It should be realized that there is little tax savings - the tax will ultimately be paid when the money is spent personally by the shareholders. However, deferring the tax is like getting an interest free loan from the government.

Note that it is not the net income that causes the deferral advantage, but rather, the amount of net income that is not required to be spent personally (ie. the amounts retained in the corporation as retained earnings).

To justify incorporation for tax reasons only would necessitate an annual tax deferral in excess of $3,000 - $5,000. This level of savings is suggested because of the initial cost of incorporating, the higher annual accounting and legal fees and because of additional administration and general red tape in a corporate structure.

Usually, only individuals with excess amounts (net incomes less the amounts required personally) of at least $10,000 may achieve such tax deferrals. The tax benefits are really only a deferral and this can only be achieved by having the corporation build up retained earnings.

In other words, shareholders must minimize withdrawals (salaries, dividends, rents, interest, etc.) from the corporation and maximize retained earnings in the corporation to achieve the greatest tax benefits. It is a form of tax shelter. The retained earnings may be reinvested in farm assets in order to achieve higher rates of growth, to pay off debt, or to purchase other assets.

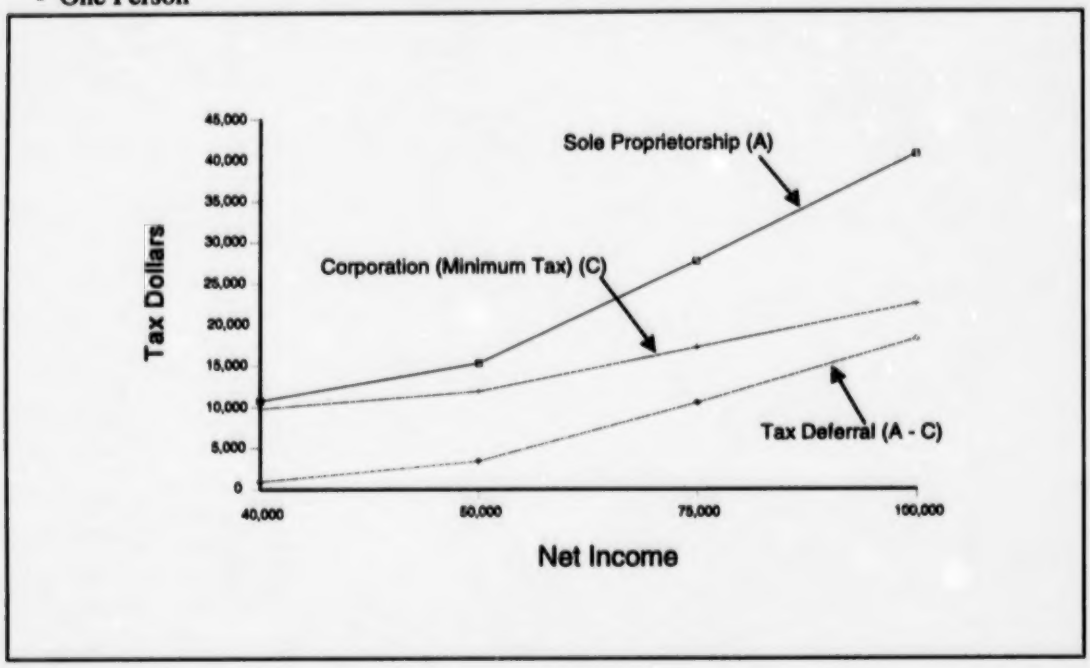
Persons considering incorporation must realize that if they wish to use all the farm profits for personal reasons or at some time in the future they wish to withdraw accumulated retained earnings for personal use, that the total corporate and personal tax will be approximately equal to the tax an individual would have paid as a proprietorship. However, the company would have had the benefit of the taxes deferred for that period of time.

There is a direct relationship between the amount of retained earnings and the value of the tax deferral. While it was suggested that only farmers with "excess amounts available" (net income less amounts required personally) in excess of $10,000 should consider incorporation for tax reasons, this is only a rough rule of thumb. Each farmer considering incorporation should calculate the tax deferral benefits for his or her own set of circumstances since variations in personal income needs, income splitting possibilities and the use of retained earnings can affect the value of a corporation for tax planning purposes.

Where a shareholder transfers property to a corporation and receives loans in exchange, the shareholder may withdraw principal on such loans tax free. This permits retained earnings to accumulate in the corporation. However, the receipt of principal on loans is not earned income for the purpose of contributions to the Canada Pension Plan or to RRSPs.

In summary, farms with relatively high levels of net income and with a growth oriented objective for the farm may find incorporation advantageous. Farmers with low levels of net income and those with relatively high levels of net income but who have large personal spending requirements may find little benefit by incorporating.

Figure 1: Total Corporate and Personal Income Tax Payable at Various Net Income Levels - One Person



Banking Arrangements

The financial affairs of the corporation must be kept separate from the financial affairs of the shareholders, employees, or directors. A separate bank account for the corporation is required. Severe income tax penalties may occur if corporate funds are used for personal use without proper accounting of such use.

The personal affairs of employees or shareholders should be conducted through a separate individual bank account.

Year End Settlements and Shareholder Advances

Advances to shareholders during the fiscal year of the corporation should be on a loan basis. On the last day of the fiscal year resolutions can be passed at a meeting which indicates how the shareholder advances during the year are to be accounted for by way of dividends, wages, interest, or repayment of shareholders' loans. Deductions from the salary must be remitted to Revenue Canada by the fifteenth day of the following month.

Advances to shareholders will be treated as income to the shareholder unless the advance or loan is repaid to the corporation within one year after the corporation's year end in which the funds were

advanced (exceptions: certain loans made to acquire a home, car or corporate shares).

Further, any low or no interest loans will result in a taxable benefit to the employee or shareholder. The taxable benefit is equal to the difference between the prescribed interest rate calculated quarterly by Revenue Canada and the interest actually paid on the loan. Any interest payable by a shareholder or employee must be paid within 30 days after the end of the year.

Auditor

By the unanimous consent of all shareholders, a corporation is not required to have an audit performed. This should be documented in the minutes of the corporation.

Decision Process

The decision process can be slower in a corporate structure than a proprietorship since certain procedures must be followed. Minutes of meetings of shareholders, officers and directors must be recorded in the minute book. Major decisions should be made at a meeting and the passing of the resolution entered into the minute book. A simple majority of the votes passed by a quorum of the shareholders will carry most decisions.

A special resolution must be passed by 2/3 of the shareholders to initiate major changes or make major decisions. A special resolution is required for such things as altering the share structure, changing the corporation's name or nature of business, restricting share transfers or changing the number of directors.

Annual Meeting

Ideally, an annual meeting should be held to review the past year's operation and financial statements, establish objectives for the next year, and appoint directors if required.

Rather than having a meeting, the requirements of The Saskatchewan Business Corporations Act can be met by all the shareholders signing a consent resolution for the annual meeting.

Annual Returns

An annual return must be filed annually with the Corporations Branch. The return must be filed within one month following the anniversary date of incorporation. The return must state the address of the registered office, the business in which the corporation is engaged; the date of the annual meeting, if held, the number of shares of each claim outstanding with the stated capital value and purchases or redemptions of shares by the corporation.

If there are fewer than 50 shareholders, each shareholder together with shares held of each class must be listed. In addition, the names, addresses and office held of each director must be stated.

Canadian Wheat Board

Under The Canadian Wheat Board Act, only actual producers of grain are permitted to apply for a Canadian Wheat Board permit book to allow delivery and sale of grain. A corporation which has grain transferred to it by a shareholder may not apply for a permit book to sell the grain. To overcome this problem, the corporation and the person who transferred the grain to the corporation can enter into a marketing agreement for the remainder of the crop year whereby the individual markets the grain on behalf of the corporation and assigns the grain cheques to the corporation.

After the corporation commences actual production, it is allowed to apply for a permit book. Only one permit book is permitted no matter how many shareholders are involved.

Prairie Grain Advance Payments Act

Corporations can borrow up to $250,000 of cash advance under The Prairie Grain Advance Payment Act no matter how many shareholders the corporation has. The interest rate is the bank prime rate less 3/4 of 1%. The Cash Flow Enhancement Program provides for a 2.25% interest rate on the first $60,000 of cash advance.

NISA

A farm corporation qualifies for its own NISA. The annual eligible net rates limit is based on the number of shareholders who are actively engaged in the farm business and who have 10% or more of voting shares. Shareholders may roll a personal NISA Fund No. 2 account into the corporation on a tax deferred basis, as part of a section 85 rollover.

Share Transfers and Reorganization

Changing the Share Structure

After the corporation is established, the share structure may be altered. This requires the passing of a "special" resolution of the shareholders to permit such changes. Special resolutions require a two-third majority.

Issuing Additional Shares

The Saskatchewan Business Corporations Act permits the corporation to redeem shares from shareholders. Depending on the rights attached to the shares, redemption of shares may be at the option of the corporation, the shareholder or by the agreement of both parties.

Shares may be issued by the corporation until the maximum number, if any, stated in the articles of the corporation have been subscribed. Shares may be issued at such times and to such persons and for such consideration as the directors may determine. Shareholders should pay the fair market value for the shares that are issued to them. If this is not the case, the existing shareholders have their share values diluted and in effect transfer a benefit to the new shareholders. Taxable benefits could occur.

Share Transfers

Shareholders may sell or transfer shares to a new shareholder subject to the bylaws or restrictions placed on the shares. Normally in a closely-held family corporation, shares may only be transferred with the permission of all or a majority of the other shareholders or the directors.

Shareholders should have a buy-sell agreement whereby if one shareholder wishes to sell his shares, or if a shareholder dies, the other shareholder(s) have the option to or requirement to buy the shares. In a buy-sell agreement, the term and interest rate is specified or else the shareholder who buys the shares is given a specified time to raise the required capital.

Another common approach to buy-sell agreements is to use the "shot gun" approach. In this scenario, a shareholder makes an offer to sell his or her shares to the other shareholders at stated terms and conditions. If the other shareholders decline, they are forced to sell their shares at those same terms and conditions, resulting in only one party owning shares after the clause is invoked.

This approach ends up with a fair price usually being reached. It is similar to having two children each wanting the last piece of cake. The approach is to give a knife to one, who gets to cut the cake into two pieces (sets the price of the offer) and the other child gets to choose which piece s/he wants (the shareholder who gets to accept to buy or must then sell her/his shares).

Life insurance is often carried on the life of each party in a buy-sell agreement to provide liquidity to purchase the shares of a deceased person.

New Shareholders

In closely-held corporations, the agreement of the existing shareholders should be required to permit new shareholders to own shares. New shareholders may obtain shares from either the corporation (whereby it issues shares to the new shareholder) or by purchasing shares from existing shareholders.

When the corporation issues shares the new shareholder should pay the fair market value for the shares. The other shareholders should agree to the number of shares of the different classes to issue to the new shareholders, since this will determine the relative division among all shareholders of future growth in the corporation. It will also determine the relative voting power and division of dividends.

If the new shareholder purchases shares from existing shareholders, each existing shareholder may wish to sell a percentage of their shares in order to maintain their relative positions in the corporation.

Rights of Minority Shareholders to Sell Shares

Minority shareholders may find it difficult to realize on the share value if they wish to sell. In a closely-held family corporation, a non-family member is unlikely to be interested in purchasing shares. In addition, there may be restrictions on the transfer of shares.

Ideally, a shareholder's agreement or buy-sell agreement should exist to permit shareholders to realize on their share value.

Income Tax on Share Transfers

Rollover of Shares between Spouses

Shares can be transferred from one spouse to another on a capital gain rollover. The transfer may occur by way of gift during an individual's lifetime or by bequest after death. This rollover provision between spouses applies to all types of assets, not only shares. However, the income tax attribution rules apply to such transfers whereby future earnings (and capital gains) are taxable income to the spouse who transferred the shares.

Rollover of Shares to Children

Shares transferred to anyone other than a spouse are deemed to be transferred at fair market value, thereby giving rise to a capital gain. There is one exception to this. This is:

Rollover of Shares in a Family Farm Corporation

Shares in a family farm corporation may be rolled over from a parent to a child (or grandchild) under certain conditions without generating a capital gain.

The rollover may occur during the share owner's lifetime or after her/his death. If the shares are sold to a child and the price exceeds the adjusted cost base of the shares, a capital gain will occur to the extent that the selling price exceeds the adjusted cost base. If the selling price is less than the adjusted cost base, the proceeds of disposition are deemed to be equal to the adjusted cost base. If the selling price exceeds the fair market value, the proceeds of disposition are deemed to be equal to the fair market value.

The child who acquires the shares must be a Canadian resident. Further, either the shareholder, his spouse or a child must be actively engaged in the farming business carried on by the corporation.

Example:

To illustrate this, consider a father transferring shares in a family farm corporation to his son. The shares have an adjusted cost base of $50,000 and

are valued at $120,000 at the time of transfer. The following table indicates the capital gain and deferral implications of various prices.

Sale Price	Father's Capital Gain	Capital Gain Deferred	Son's Adjusted Cost Base
$ 1*	$ 0	$70,000	$ 50,000
$ 25,000*	$ 0	$70,000	$ 50,000
$ 50,000	$ 0	$70,000	$ 50,000
$100,000	$ 50,000	$20,000	$100,000
$120,000	$ 70,000	$ 0	$120,000

* Sale price deemed (assumed) to be $50,000.

Normally, the sales price should be between the adjusted cost base and the fair market value (between $50,000 - $120,000 in this example) to avoid negative tax consequences. If the father later wants to gift the $50,000 to the son, there would usually be no ill tax consequences. If the son wants to give more than $120,000 he would normally make the purchase at $120,000 and then gift the excess amount separately.

Capital Gains Exemption

Shares transferred for an amount in excess of adjusted cost base are eligible for the Capital Gains Exemption. However, preferred shares issued under a Section 85 rollover, which are redeemed by the corporation would not - they are deemed dividends.

Alternative Minimum Tax

The disposition of shares which result in a capital gain may be offset with the Capital Gains Exemption. However, such gains may be subject to alternative minimum tax.

Withdrawal of a Shareholder

A shareholder may withdraw from a corporation and establish his own separate business. It is possible for him to withdraw a portion of all the assets of the original corporation by transferring these assets to another corporation without generating a capital gain. The procedures are quite complex and the accounting and legal advice would likely be costly.

Estate Planning

Estate planning may be simpler in a corporate structure than in a proprietorship. It is easier to transfer the business on a gradual basis by means of transferring shares, rather than land, equipment, buildings, livestock and other specific assets.

Ownership, control and the right to profit (dividends) can be separated in a corporation through the share structure. For retirement purposes it would be possible to transfer ownership yet retain the control and right to profit.

Estate freezes can be accomplished in a corporation whereby a shareholder's estate can be prevented from growing in value after the corporation is established. The growth may be transferred to other shareholders by means of an appropriate share structure. Estate freezing with children is often not required, since the rollover provisions often achieve similar results without the extra accounting costs.

At the time of a farmer's death, his rights and things (e.g., grain and livestock of a cash basis farmer) could have a high value and may result in a large income tax liability. A corporation owns these assets, therefore, when a shareholder dies, there would be a lesser tax liability for rights and things.

Dissolution of a Corporation

A corporation may be dissolved or wound up voluntarily or involuntarily.

If it is wound up involuntarily, it may be as a result of its creditors petitioning it into bankruptcy under

the Bankruptcy and Insolvency Act or under certain provisions of The Business Corporations Act for failure to comply with certain requirements of The Business Corporations Act (Saskatchewan). A trustee is appointed to administer the affairs of the corporation until it is wound up.

The provisions for voluntary dissolution would be based on the corporation's bylaws or The Saskatchewan Business Corporations Act. The corporation sells its assets at fair market value. Any income tax payable and other debts of the corporation are paid and the balance remaining is distributed to the shareholders as dividends.

The main cost at dissolution of a farm company would be income tax payable, since a large accrued capital gain normally exists on the land (unless it was originally sold to the corporation at fair market value), recaptured capital cost allowance may occur on machinery, and the value of grain and livestock becomes taxable income.

If land were transferred back to a shareholder, the corporation is deemed to receive proceeds equal to fair market value. If the land increased in value, the corporation would have a capital gain (a corporation is not eligible for a Capital Gains Exemption). Further, the shareholder must assume debts of the corporation or pay in funds that equal the fair market value of the land received. These funds could only be withdrawn in the form of dividends which are taxable income.

If funds paid to the corporation plus assumed debt do not equal the fair market value of the land, then the shareholder is deemed to receive a taxable benefit equal to the deficiency.

There are no tax averaging provisions available to the corporation for the above types of situations. Legal and accounting costs will also be incurred to dissolve the corporation.

Should You Incorporate the Farm?

The size of the operation, tax deferral, tax saving, income splitting, the number of individuals providing capital, labour and management, as well as their outside interests, are major factors in determining the best type of business organization.

A farm family should not dismiss incorporation simply because they do not understand its technicalities. Time, energy and some money must be invested to get the complete picture. Both the advantages and disadvantages must be considered carefully. Your objectives might be better realized through the present farm structure, a father-son joint venture, partnership, agreement for sale, estate planning, etc. These should all be considered.

As a general rule of thumb, farmers should have an "excess amount" of net income over the amounts required for personal spending which is consistently above $10,000 before there is likely to be a significant income tax advantage to incorporation. In some cases the legal benefits and family operating advantages that may occur from the corporate form of organization will make incorporation worthwhile at lower levels of "excess amounts". Situations where a farm may consider incorporation other than for income tax reasons are as follows:

Bringing a New Person into an Existing Farm Business Arrangement

Often a son, brother or son-in-law joins an existing farm business arrangement. The new farmer will have large debts and a high debt servicing requirement in relation to his share of the income from the total farm operation.

By incorporating, the existing members of the organization can freeze their equity at the time of entry of the new member (although there may be

additional accounting costs at that time). The corporation may acquire the assets that the new member would have otherwise acquired and spread the debt servicing requirement over a larger financial base. All shareholders will share the corporation's future growth based on the share structure determined at the time of incorporation.

Second Marriages

Occasionally, a man or woman with children may bring assets into a second marriage. By incorporating, each party can freeze the value of their equity at the time of marriage for the benefit of their children (again, there may be additional accounting costs to consider). The future growth in asset value and equity can then accrue to the new family unit.

Farmers Who Do Not Qualify for Capital Gain Rollovers

A bachelor with farm assets is unable to transfer any of his assets to beneficiaries on a capital gain rollover although he may qualify for the Capital Gains Exemption. By incorporating, he could freeze his equity at that time and have the corporation issue common shares to his intended beneficiaries. The beneficiaries would receive the future growth of the corporation. At the bachelor's death, only the capital gain realized up to the time of incorporation would be taxable in the estate (subject to the Capital Gains Exemption).

It may be possible in the previous situation to have the bachelor gradually reduce the capital gain liability during his life. When the assets are transferred to the corporation, preferred shares with a paid up capital equal to the deferred capital gain on the assets are issued to the bachelor. Each year the corporation could redeem a portion of the preferred shares which result in taxable dividends to the bachelor. Dividends may be taxed at a low rate. Over time the capital gain liability on the preferred shares could be eliminated, perhaps without paying a lot of income tax. This would depend on the individual's personal situation and other income.

There are many risks and considerations in this approach. If the bachelor died, a deemed capital gain on the preferred shares would occur to the estate if his will directed that the beneficiaries receive the shares (as compared to a deemed dividend if redeemed by the corporation). However, this may be eligible for the lifetime Capital Gains Exemption. Expert advice should be obtained to determine the tax consequences of all alternatives and the risks appraised.

Before incorporating, discuss your plans with a friend or neighbour who is already incorporated.

If you decide to incorporate, obtain expert legal and accounting advice early in the process.

Appendix I

Sample Farm Corporation Financial Statements

The following example shows the financial situation prior to incorporation, the share structure and transfer of assets to the corporation and the corporation's balance sheet.

The Situation Prior to Incorporation

The Family: Mr. Jones, age 52; Mrs. Jones, age 50; Jack Jones, son, age 23; Jane Jones, daughter, age 18.

The Farm: Mr. Jones operates a three section grain farm. His son Jack recently purchased land; he also leases land and uses some of his dad's machinery.

The Plans: Mr. Jones plans to farm for several more years. He has been paying a large amount of income tax in recent years (average of $70,000 taxable income over past four years). Jack would like to increase the size of his farming operation. He is not paying income tax at the present time. Mr. Jones and Jack decide to establish a corporation as a means of establishing a more formalized business arrangement and also to reduce Mr. Jones' income tax.

Mr. Jones' Assets and Liabilities

	Fair Market Value	Adjusted Cost Base	
Assets			
Land 1920 acres	$ 800,000	$100,000	
House (Principal Residence) (1/4 business)	50,000	40,000	
Buildings (Part XVII)	10,000	10,000	
Buildings (Part XI)	40,000	50,000	cost
		25,000	U.C.C.*
Machinery (Part XI)	200,000	250,000	cost
		80,000	U.C.C.*
Grain and Supplies	150,000	N.A.	
	$1,250,000		
Liabilities			
Land Mortgage	$ 50,000		
Machinery	65,000		
Total	$ 115,000		
Net Worth	$1,135,000		

Jack Jones' Assets and Liabilities

	Fair Market Value	Adjusted Cost Base	
Assets			
Land 480 acres	$224,000	$144,000	
Buildings (Part XI)	10,000	12,000	cost
		9,000	U.C.C.*
Machinery (Part XI)	20,000	25,000	cost
		16,000	U.C.C.*
Grain and Supplies	26,000	N.A.	
	$280,000		
Liabilities			
Land Mortgage	$140,000		
Machinery	25,000		
Total	$165,000		
Net Worth	$115,000		

Share Structure

The share structure must be developed in a manner that is consistent with the method of transferring assets to the corporation and in relation to the desired division of future dividends and corporate growth. It was decided that Mr. and Mrs. Jones would each acquire 30% of the voting rights and also the right to future growth while Jack Jones would obtain 40% of the voting power and growth. It should be noted that the division of voting powers and growth could be different by utilizing a different share structure.

The following share structure was established.

Shares issued	Mr. Jones	Mrs. Jones	Jack Jones
100 common voting shares at $1/share	30	30	40
516,000 preferred redeemable retractable non-voting shares at $1/share	485,000	Nil	31,000

Cash is paid for the common shares from each person's own source of funds. Mr. Jones would pay $30.00, Mrs. Jones $30.00 and Jack Jones $40.00 for the common shares. The preferred shares are issued to Mr. Jones and Jack Jones as part of the consideration for the transfers of their assets to the corporation.

Transfer of Assets to the Corporation

Mr. Jones transfers all his assets except the house to the corporation and has the corporation assume his liabilities. Land is transferred at a value which generates $500,000 of capital gain in order to utilize the

Capital Gains Exemption. The balance of the land value is rolled to the corporation under Section 85 of the Income Tax Act. Jack Jones fair transfers his assets at fair market value to utilize the Capital Gains Exemption and has the corporation assume his liabilities. Preferred shares which are retractable and redeemable are issued to avoid deemed gifts and capital gains.

Mr. Jones' Transfer to the Corporation

	Elected Transfer Amount	Preferred Shares Issued
Land	$600,000	$200,000
Building Part XVII	10,000	0
Building Part XI	25,000	15,000
Machinery Part XI	80,000	120,000
Grain and Supplies	0	150,000
Sub Total	$715,000	$485,000
Less Liabilities assumed by the Corporation	$115,000	$ 0
Shareholder's Loan	$600,000	$485,000

Mr. Jones' Net Worth after incorporation is as follows:

House	$ 50,000
Preferred Shares	485,000
Shareholder's Loan	600,000
30 Common Shares at $1.00	30
Total	$1,135,030
Liabilities (cash to purchase shares)	30
Net Worth	$1,135,000

Jack Jones' Transfer to the Corporation

	Elected Transfer Amount	Preferred Shares Issued
Land	$244,000	$ 0
Building Part XI	9,000	1,000
Machinery Part XI	16,000	4,000
Grain and Supplies	0	26,000
Subtotal	$249,000	$ 31,000
Less Liabilities assumed by the Corporation	$165,000	$ 0
Shareholder's Loan	$ 84,000	$ 31,000

Jack Jones' Net Worth after incorporation is as follows:

Preferred Shares	$ 31,000
Shareholders Loan	84,000
40 Common Shares at $1.00	40
Total	$115,040
Liabilities (Cash to purchase shares)	40
Net Worth	$115,000

Mrs. Jones' Situation

Mrs. Jones purchases 30 common shares at $1.00/share from her own source of cash. As with Mr. Jones and Jack her net worth does not change as a result of incorporation.

Balance Sheet of the Corporation after Incorporation

Assets

Land 2400 acres	$1,024,000
Buildings (Part XI)	60,000
Machinery (Part XI)	220,000
Grain and Supplies	176,000
Cash (paid for common shares)	100
	$1,480,100

Liabilities

Land Mortgages	$ 190,000
Machinery	90,000
Mr. Jones' Shareholder Loan	600,000
Jack Jones' Shareholder Loan	84,000
Total liabilities	$ 964,000
Owner's Equity	
516,000 preferred redeemable retractable non-voting shares at $1/share	$ 516,000
100 common voting shares at $1/share	100
Total Liabilities and Owner's Equity	$1,480,100

Future growth in the corporation as a result of capital gain, debt reduction or retained earnings will increase the value of the common shares. For example, if after one year the total assets are $1,600,000 and the total liabilities are $930,000 and there are 516,000 preferred shares at $1.00 per share, then the common shares have a value of $1,600,000 - 930,000 - 516,000 = $154,000. This is $154,000/100 = 1,540 per share.

The equity ownership in common shares would then be as follows:

Mr. Jones' 30 shares x $1,540/share	= $ 46,200
Mrs. Jones' 30 shares x $1,540/share	= $ 46,200
Jack Jones' 40 shares x $1,540/share	= $ 61,600
Total	$154,000

If corporation meets the requirements of a family farm corporation, both Mr. and Mrs. Jones could transfer shares to their Jack or Jane at $1.00 per share on a capital gain rollover.